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IN THE

SUPREME COURT

OF THE

UNITED STATES.

October Term, 1935.

No. 525.

Great Western Power Company of California,

Petitioner,

vs.

Commissioner of Internal Revenue,

Respondent.

ON WRIT OF CERTIORARI TO THE CIRCUIT COURT OF APPEALS, SECOND CIRCUIT.

BRIEF FOR PETITIONER.

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I.

OPINIONS.

The opinion of the United States Board of Tax Appeals [R. p. 35] is reported in 30 B. T. A. 503. The opinion of the United States Circuit Court of Appeals, Second Circuit [R. p. 137], is reported in 79 Fed. (2d) 94.

II.

STATEMENT OF THE CASE.

(1) History of Case.

In determining the deficiency here involved for the year 1924, the respondent denied to the petitioner a deduction for unamortized discount and expense of issuance, premiums paid on retirement, and expense of retirement of those General Lien Convertible 8% Gold Bonds which were retired for cash, and also denied a similar deduction for like items in connection with the retirement of such bonds by the issuance of new bonds and the payment of a premium in cash. The petitioner appealed to the Board of Tax Appeals on these and other issues. On the hearing before the Board of Tax Appeals the respondent conceded the deduction with respect to the bonds retired by the payment of cash.

The Board of Tax Appeals held that both deductions were allowable and the respondent appealed to the Circuit Court of Appeals for the Second Circuit where he admitted the correctness of the Board's ruling with respect to discount and expense and premiums paid on the bonds retired for cash, but contended that no deduction was allowable with respect to the bonds retired by the issuance of new bonds. The said Circuit Court of Appeals agreed with the respondent and held:

> (1) That the deduction was allowable with respect to the unamortized discount and expense and premiums paid in the retirement of those bonds which were retired for cash at face value plus a 5% cash premium;

(2) That the deduction of such items was not allowable with respect to those bonds which were retired by the issuance of new bonds and the payment of a 5% cash premium; and

(3) That the unamortized discount and expense of issuance and premiums paid on retirement of the old bonds should be amortized over the term of the new bonds issued in exchange therefor.

In holding that the unamortized discount and expense and premiums paid on the old bonds retired were not deductible, the court held that the loss was not realized in 1924 and would not be realized until the new bonds issued in exchange therefor were to be retired.

(2) Facts.

On March 1, 1919, petitioner executed a trust indenture entitled "First and Refunding Mortgage" by which it conveyed all of its properties then owned and thereafter to be acquired to a corporate trustee as security for certain bonds to be thereafter issued pursuant to the terms of such indenture. Under this indenture petitioner issued four series of bonds entitled "First and Refunding Mortgage Sinking Fund Gold Bonds," the individual series being styled "Series A 6%," "Series B 7%," "Series C 6%" and "Series D 5½%," respectively [R. p. 66]. The only one of the above series material to the instant case is the "Series B 7%."

The "Series B 7% First and Refunding Sinking Fund Gold Bonds" (hereinafter referred to simply as the "Series B 7's") were dated August 1, 1920, and were due August 1, 1950. These bonds were issued during the year 1921,

the face amount of the issue being $8,500,000.00 [R. pp. 66. 80, 86, 87].

On February 1, 1921, petitioner executed another trust indenture entitled "General Lien Indenture" by which it conveyed all of its properties, subject to prior encumbrances, to another corporate trustee as security for another issue of bonds to be known as the General Lien Convertible 8% Gold Bonds (hereinafter referred to as the "General Lien 8's") [R. p. 99]. As further security for those who would become the holders of these General Lien 8's the indenture also provided that petitioner would, as promptly as possible under the laws of the State of California and the provision of the First and Refunding Mortgage, deposit and pledge with the trustee under the General Lien Indenture Series B 7's equal in par value to the General Lien 8's at any time issued and outstanding [R. p. 101].

During the year 1921 petitioner issued and sold to the public $2,500,000.00 face value of its General Lien 8's, the bonds being dated August 1, 1920, and due August 1, 1935 [R. p. 67]. During the same year petitioner issued and delivered to the General Lien trustees, as the additional security above referred to, a like amount of the Series B 7's [R. p. 69.]

The General Lien Indenture contained the following provision with regard to the redemption and conversion of the bonds issued thereunder:

"(Art. IV) REDEMPTION AND CONVERSION OF BONDS * * *

"SECTION 1. At any time when Series B bonds of the Company equal in par value to the par value of the bonds issued hereunder and then outstanding, shall be pledged and deposited with the Trustee hereunder, the Company may, at its option, redeem on any interest payment date, at the price of 105 together with accrued interest, all or any of the bonds issued hereunder and then outstanding; * * * [R. p. 101].

"SECTION 2. The holders of any and all bonds called for redemption shall have the option (to be exercised not later than the redemption date thereof) either of receiving payment for such bonds in cash at said price of 105 together with accrued interest, or of receiving for such bonds Series B bonds of the Company (with the coupon maturing on the interest payment date next following the redemption date and all subsequent coupons attached) equal in par value to the par value of the said bonds so called for redemption, and a premium in cash of five per cent. of the face value thereof and interest thereon to date of redemption. * * *" [R. p. 102.]

The General Lien 8's were issued (1921) at a discount of $150,000.00 and at an expense of $22,283.54 [R. p. 67]. Prior to December 31, 1923, petitioner had retired $11,000.00 face value of the General Lien 8's for cash and charged off in the year of retirement the then unamortized portion of the above discount and expense applicable to the bonds so retired [R. p. 67].

On May 8, 1924, $2,489,000.00 face value of the General Lien 8's were outstanding in the hands of the public, and on that date petitioner's Board of Directors passed a resolution calling all of such outstanding bonds for redemption on August 1, 1924, according to the terms of the General Lien Indenture [R. p. 67].

On August 1, 1924, the holders of $2,354,000.00 face value of the General Lien 8's exercised the option granted to them by the General Lien Indenture and exchanged their bonds for a like face amount of the Series B 7's. In addition to the Series B 7's received on this exchange each of the General Lien 8 holders received a cash premium equal to 5% of the face value of his General Lien 8's surrendered. The total premiums paid to the holders of the General Lien 8's so exchanged amounted to $117,725.00 and the expense of conversion was $1,461.05. The unamortized discount and expense of issuance applicable to the General Lien 8's so exchanged amounted, at the date of the exchange, to $126,176.97 [R. pp. 67-68.]

The $134,500.00 face value of the General Lien 8's which were not exchanged for Series B 7's were retired, by cash, as of August 1, 1924. A 5% cash premium was also paid to the holders of these bonds and the expense of retirement amounted to $83.46. The unamortized discount and expense applicable to these bonds at the time of retirement amounted to $7,207.82 [R. p. 68].

The respondent has conceded that the unamortized discount and expense of issuance, premiums paid, and ex-

pense of retirement applicable to the General Lien 8's which were retired for cash are allowable deductions for the year 1924 [R. p. 68], but contends that the same items applicable to the General Lien 8's exchanged for Series B 7's are not allowable deductions for 1924, but should be amortized over the lives of the Series B 7's. Petitioner agrees with the respondent with respect to the treatment of the items applicable to the General Lien 8's retired for cash, but contends that the same rule should be applied to the same items on the bonds exchanged.

III.

SPECIFICATION OF ERRORS RELIED UPON.

(1) The United States Circuit Court of Appeals for the Second Circuit erred in reversing the Board and in holding that the sum of $245,363.02 representing premiums, unamortized discount and expenses paid by petitioner in the retirement of $2,354,500.00 face amount of its General Lien 8% bonds was not deductible in the determination of petitioner's net taxable income for the year 1924.

(2) The United States Circuit Court of Appeals for the Second Circuit erred in reversing the decision of the United States Board of Tax Appeals.

(3) The United States Circuit Court of Appeals for the Second Circuit erred in failing to follow the decision of the United States Circuit Court of Appeals for the Ninth Circuit in the case of *San Joaquin Light & Power Corporation v. John P. McLaughlin, Collector of Internal Revenue,* 65 F. (2d) 677.

IV.

QUESTION INVOLVED

Is the Petitioner in the Determination of Its Net Taxable Income for the Year 1924 Entitled to Take as a Deduction on Account of the Retirement of Its Bonds the Unamortized Discount and Expenses of Issuing Said Bonds and Expenses and Premiums Paid in the Retirement Thereof?

V.

ARGUMENT.

Article 545 of Regulations 65 Specifically Allows the Deduction Claimed by the Petitioner.

Article 545 of Regulations 65 promulgated under the Revenue Act of 1924 provides that where bonds are issued by a corporation at a discount and later such bonds are purchased and retired, the excess of the purchase price over the face value minus any amount of discount deducted is a deductible *expense* for the taxable year of retirement.

This article has appeared without substantial change in each of the Regulations promulgated by the Commissioner under each of the Revenue Acts from 1918 to 1934, both inclusive, and since the article first appeared in its present form Congress has six times re-enacted the statute upon which it is based. The repeated reenactment of the statute in the face of this consistent administrative construction constitutes legislative approval of the statute so construed. (*National Lead Company v. United States,* 252 U. S. 140; *Brewster v. Gage,* 280 U. S. 327; *Universal Battery Co. v. United States,* 281 U. S. 580; *Fawcus Machine Co. v. United States,* 282 U. S. 375;

McCaughn v. Hershey Chocolate Co., 283 U. S. 488; *Murphy Oil Co. v. Burnet*, 287 U. S. 299.)

In addition to the legislative approval of this regulation this Honorable Court has expressly approved the article in the case of *United States v. Kirby Lumber Co.*, 284 U. S. 1, and has recently followed the doctrine of the *Kirby* case in *Helvering v. American Chicle Co.*, 291 U. S. 426.

Although Article 545 does not expressly cover the items other than discount and premiums, it has been held that the expense of issuing bonds is an additional cost of the capital secured and may be treated in the same manner as discount. (*Helvering v. Union Pacific R. R. Co.*, 79 L. E. Adv. Op. 145; *Helvering v. California Oregon Power Co.*, 75 Fed. (2) 644.) It has also been held that retirement expenses are deductible in the same manner as unamortized discount and expense of issuance. (*San Joaquin Light and Power Co. v. McLaughlin*, 65 Fed. (2) 677; *Helvering v. California Oregon Power Co.*, 75 Fed. (2) 644.)

Interpreting Artiele 545 in the light of the above cited cases, the courts have uniformly held that where an issue of bonds is retired for cash, *even though that cash be derived from the sale of a new issue of bonds*, the unamortized discount and expense applicable to the bonds retired, the premiums paid on retirement, and the expenses of retirement are all properly deductible in the year of retirement. (*Helvering v. California Oregon Power Co.*, 75 Fed. (2) 644, (C. A. of D. C.); *Helvering v. Central States Electric Corp.*, 76 Fed. (2) 1011 (C. C. A. 2); *Helvering v. Union Public Service Co.*, 75 Fed. (2) 723 (C. C. A. 8); *San Joaquin Light and Power Co. v. McLaughlin*, 65 Fed. (2) 677 (C. C. A. 9).

The Treasury Department also recognizes the propriety of such deductions in the case of bonds so retired. (T. D. 4603, XIV C. B. 46, p. 3.)

In view of this well settled construction of Article 545 the instant case seems to be resolved into a single question: Is there such a difference between bonds retired by cash secured from the sale of new bonds, and bonds retired by means of a direct exchange, as warrants the use of a different method of treating the items of unamortized discount and expense, premiums paid on retirement, and retirement expenses?

It is respectfully submitted that insofar as Article 545 is concerned, there is no difference whatever between these two types of retirement. The article simply states that if the bonds are "purchased and retired" the deduction is allowable; it does *not* limit the deduction to those cases in which the bonds are retired for *cash*. Moreover, we do not believe that any such limitation may be implied to the article. In neither its technical nor common meaning does the word "purchase" imply solely the use of money. Technically the word purchase includes all modes of acquisition other than that of descent (*Kohl v. United States,* 91 U. S. 367, 74); commonly it means to obtain anything by any outlay, as of labor, etc., or by paying money or its equivalent (Webster); and "generally, in statutes as in common use, the word is employed in a sense not technical, only as meaning acquisition by contract between the parties without governmental interference". (*Kohl v. United States,* 91 U. S. 367, 74.)

In this connection, it is interesting to note that in the case of *Commissioner of Internal Revenue v. Coastwise Transportation Co.,* 62 Fed. (2) 332; 71 Fed. (2d) 104,

the Circuit Court of Appeals for the First Circuit held that where a corporation retired its notes by exchanging its bonds therefor the transaction constituted a "purchase" of the notes within the meaning of Article 545 with a resultant taxable gain to the taxpayer. Clearly, we believe, if such an exchange was properly classed as a "purchase" for the purpose of fixing a taxable gain within the meaning of the Article, then a similar exchange must likewise be classed as a purchase for the purpose of fixing the amount of an allowable deduction within the meaning of the same Article.

We repeat, then, that insofar as the wording of Article 545 is concerned, there appears to be no reasonable ground of distinction between bonds retired for cash and bonds retired by an exchange of other bonds.

The theory advanced by the petitioner here is supported by the decision of the Board below and by the prevailing opinion in *San Joaquin v. McLaughlin,* 65 Fed. (2d) 677 (C. C. A. 9). On the other hand, the respondent's theory is supported by the decision of the court below and by the dissenting opinion in the *San Joaquin* case. Under the petitioner's theory the total amount of the unamortized discount and expense and premium paid upon the redemption of the General Lien 8's would be deductible in the year 1924 because the transaction was concluded in that year by the redemption of the old bonds and the extinguishment of the obligation. Under the respondent's theory, however, the obligation of the new bonds simply took the place of the obligation of the old and, therefore, no loss was realized in the year 1924. Under this theory the unamortized discount and expense and the premiums paid on account of the old bonds would be amortized over the life of the new issue.

We think that little can be accomplished by a discussion of the merits of these two theories. It seems sufficient to point out that at the time the respondent first issued his regulations on the subject of bond discount which, as we have seen, have received legislative approval, he undoubtedly knew of the different types of bond issues and also knew that frequently under various conditions old bonds are purchased and retired, *i. e.*, paid off, by the issuance of new bonds. Notwithstanding this he, nevertheless, promulgated his regulation and made no distinction therein between the bond "purchased and retired" for cash and the bond "purchased and retired" by the issuance of a new bond. That his regulation was a reasonable one is demonstrated by the fact, as heretofore shown, that it has received the approval of the courts and the Board of Tax Appeals. It is also reasonable from the standpoint of good accounting and conforms to accepted corporate accounting practices. Furthermore, it is reasonable from the standpoint of administration of the tax laws for the reason that it does not permit of pyramiding of bond discount and premiums from one issue to another; whereas it appears that if the opinion of the court below is to prevail, certain bond issues presently outstanding will have to carry annual amortization for, perhaps, several predecessor issues with the complications naturally attendant.

The Commissioner's regulation T. R. 65, Art. 545, was first promulgated at T. R. 45, Art. 544, in 1919. It seems significant that no case in which the present issue is involved came before the courts for more than ten years after the regulation was first promulgated; yet there were undoubtedly many cases in which the issue might have been raised.

Conclusion.

In conclusion, we submit that regardless of which of the two theories above mentioned one may adopt, he is, nevertheless, faced with the fact that the Treasury Regulations cover the point specifically and allow unamortized discount and expense and premiums paid upon retirement of bonds as deductions in the year in which such bonds are "purchased and retired"; that the particular regulation involved has the force and effect of law by reason of legislative approval; and that if the rule is to be changed it must be changed by Congress.

Respectfully submitted,

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